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1961

## FIRST NATIONAL CITY BANK

### Monthly Letter

## Business and Economic Conditions

### General Business Conditions

New York, January 1961

**T**HE downward drift in industrial activity continued in December, closing a disappointing fourth quarter. Many observers had hoped for a pickup in steel mill operations before the end of the quarter, on the grounds that stocks of steel had been cut to a minimum and that output must rise to supply daily demands. But this has not occurred. Although total employment no doubt set a December record, unemployment appears to have risen again. Christmas season sales were good but not up to expectations.

In fact, this last theme has persisted throughout the economy. As a whole 1960 was a good year—but not good enough. Generally speaking, and of course with conspicuous exceptions, performance has not come up to expectations either in volume or profit. Most comprehensive measures of business activity rose to new records; yet the fact that a half-trillion-dollar economy was finally achieved has seemed to most people less significant than the complaints that

growth was not fast enough. One trouble was that a year ago the prospects for the Sixties generally and 1960 in particular were painted in too glowing colors. Exuberant forecasts of sales and profits soon proved to have been over-optimistic, and retrenchment got under way. Economic activity stabilized and then declined; instead of the expected climb, there was a slide.

Until recently there had been considerable controversy over how to describe the business changes taking place. Was the economy in a recession virtually from the beginning of the year, or was it in a period of high level stability or adjustment with an upturn just around the corner? Would the period of contraction be brief and shallow or long and deep? Some pertinent comments were made on December 7 by one of the nation's leading authorities on business indicators, Dr. Geoffrey H. Moore of the National Bureau of Economic Research, in testimony before the Joint Economic Committee of Congress:

First, I think a peak in business activity was reached in or around May 1960 and that a contraction has been under way since then. Second, there have been a few preliminary developments of the sort that usually precede an upturn but they are not yet decisive enough to suggest that the upturn is in sight. Third, there are some tentative indications that this contraction will be relatively mild.

### Manufacturing on a Downgrade

Since the adjustment so far has been most pronounced in inventories and capital goods outlays, the effects have been most noticeable in manufacturing activity. Industrial production, as measured by the Reserve Board's index (seasonally adjusted, 1957 = 100), declined by 1½ per cent from October to 104.8 in November. Measured against the record peak early in the year, the November index was down 5.6 per cent, exactly the same percentage that the November 1957 index was down from the preceding high. In the 1957-58 downswing, the contraction lasted only five months after November 1957 and industrial

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production dropped 9.5 per cent further. But history does not always repeat itself; most economists doubt that this much contraction lies ahead in the present instance.

The November figures showed that the decline in activity was becoming more general. Only two of the major industries covered by the Board's indexes had not turned down; printing and publishing reached a new peak, while foods and beverages continued at the high level first reached last July. The other industries were down varying amounts from their peaks, led by the 43 per cent decline in the iron and steel index.

Holiday shutdowns cut scheduled steel production in the last week of the year to 1,122,000 tons. Some improvement in activity, however, is in prospect. A moderate pickup in steel buying has appeared, and enough orders for January delivery are already on hand to justify a slight increase in operations.

Automobile output also declined in December to about 523,000 passenger cars from 597,100 in November. Nevertheless, production continued to run moderately ahead of dealer sales, pushing inventories over a million cars. Further cutbacks in assemblies are expected during the first quarter to limit inventory accumulation. During 1960, nearly half a million of the 6.7 million cars produced went to build inventories, which were subnormal at the start of the year as a result of the steel strike. Expectations are that auto output in 1961 will fall short of 1960 even if forecasts by industry executives are fulfilled and sales

in 1961 duplicate the 1960 result of 6.1 million domestic and 500,000 foreign cars.

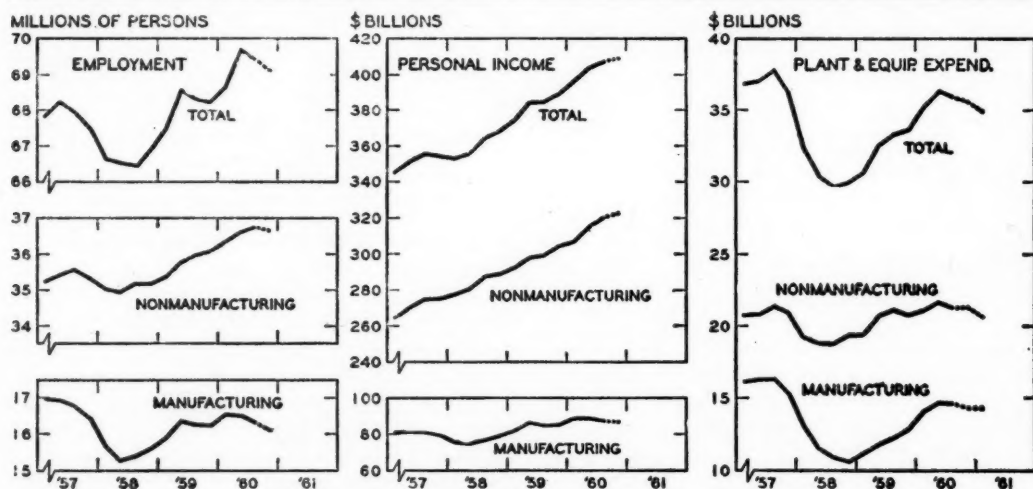
The extent to which the contraction hit manufacturing industries earlier and harder than the economy generally is demonstrated by the accompanying chart.

Manufacturing employment recovered slowly from the 1958 drop, and in fact had not regained its 1957 level before it turned down. The number of nonfarm, nonmanufacturing employees continued to rise for six months longer, and the moderate reduction of 146,000 such workers (0.4 per cent) between August and November contrasts sharply with the cutback of 498,000 manufacturing jobs, or 3 per cent, since the peak last February.

The lack of industrial job opportunities has been a major factor in the rise of unemployment to over 4 million persons in November, equivalent to a seasonally adjusted rate of 6.3 per cent of the labor force. Even with no further deterioration in the economy, seasonal factors are likely to increase unemployment to about 5,250,000 in January, according to the Labor Department.

#### Income Still High

One of the few comprehensive economic indicators which has not turned down is personal income. After rising steadily to a seasonally adjusted annual rate of \$409.5 billion in October, income leveled off in November, but the fourth quarter as a whole still seems likely to set a record. Manufacturing payrolls have been drift-



Employment, Income, and Capital Outlays in Manufacturing and Nonmanufacturing Industries

Sources: U.S. Departments of Labor and Commerce; Securities and Exchange Commission. Quarterly data at seasonally adjusted annual rates; for income and employment, fourth quarter estimated from October and November data. Total employment is based on U.S. Bureau of the Census surveys and includes armed services, farm workers, self-employed persons, and others not covered in the other employment series which are based on civilian payroll data.

ing lower since May and by November were running \$3 billion a year below their high. But other income has been rising steadily, as it did virtually throughout the 1957-58 recession, and has more than offset the slippage in manufacturing. The annual rate of other wage and salary payments rose \$3.8 billion, May to November, split about evenly between private and government pay. Transfer payments, mainly unemployment insurance and social security benefits, increased \$2 billion.

The strength in personal income has helped to sustain consumer spending, but at a level that has left disappointments among retailers. A last-minute buying rush brought Christmas season retail sales beyond the record 1959 level. Retailers, with the benefit of two extra shopping days between Thanksgiving and Christmas, managed to recoup sales losses experienced from stormy weather. Department stores reported that sales in the four weeks ended December 24 were 4 per cent above those in the four weeks ended December 26, 1959.

#### **Downturn in Investment**

The greater volatility in manufacturing is also demonstrated in the right-hand panel of the chart. In the 1957-58 recession, manufacturers' investment in new plant and equipment dropped 35 per cent compared with a 12 per cent decline in capital spending by nonmanufacturing firms. In the current dip, the differences between the two series have not been so striking. A survey conducted in November by the U.S. Department of Commerce and the Securities and Exchange Commission showed that manufacturing investment in 1960 failed to regain its 1957 quarterly peak rate of \$16.4 billion a year. After reaching a \$14.7 billion rate in the second quarter of 1960 it turned down and was expected to be off 3 per cent by the fourth quarter.

Nonmanufacturing investment reached a new record rate of \$21.6 billion in the second quarter, declined 1½ per cent by the fourth quarter, and is tentatively scheduled to decline 3 per cent further in the first quarter of 1961. Utilities and communications are maintaining high rates of investment, but railroads and other transportation are cutting back their spending in early 1961.

Total plant and equipment expenditures are now expected to be no more than \$35.7 billion in 1960, although last spring it was anticipated that they would match the 1957 peak of \$37.0 billion. The cutbacks in investment reflect increasing disappointment in sales performance and profit margins as the year progressed. These developments are also influencing business planning for

new capital expenditures in 1961; outlays in the first quarter are scheduled at a \$34.9 billion annual rate, and further reductions seem likely.

#### **Prescription for Progress**

This month, with the advent of a new Administration and the opening of another legislative session, the Congress will consider many programs designed to ensure a fuller utilization of our productive potential, speed our economic growth, and protect our industrial leadership among the nations. It is a challenging problem, finding ways to stimulate the economy without setting off an inflationary surge that will price American goods out of foreign markets and create a flight from the dollar.

The objective is not simply one of trying to prevent a deepening business recession; we have already at work cushioning factors such as rising unemployment compensation payments, a swing of the federal budget position toward a deficit as a result mainly of continuing decline in corporate profits, and a readier availability of credit following the November-December reductions in bank cash reserve requirements.

The larger objective should be to release the power of a free enterprise economy and accelerate our forward momentum in a lasting way.

The experience in dealing with the 1958 business recession shows us that the combination of enlarged Congressional appropriations and a cheap money policy would be at once inappropriate and inadequate. We got out of the business recession all right but at the cost of a \$12 billion federal deficit, a collapse of an overbullied bond market, an outburst of inflationary fears, and the initiation of a major gold outflow which still has not completely run its course. And even though we achieved new peaks of production and employment in 1959-60, the vigor of the economy did not assert itself in full force, as evidenced in the complaints about our economic growth and areas of under-utilization of labor and plant resources.

There is imperative need to find a better way, one that avoids an aftermath of problems and gives promise of sustained and balanced prosperity to be shared by all sectors of the economy.

One environmental condition, necessary in any case, is a recognition by trade union leaders that prosperity requires profits as well as wages and employment, and capital expenditure as well as consumption expenditure. No line of policy can give us a stable dollar together with high levels of employment if we are going to have continuing pressures of employment costs eat-

ing into profit margins and compelling price advances which result in reduced sales. This is the road to stagnation.

### **Getting Down to Fundamentals**

If this essential condition is fulfilled, it should be possible to find a new and better fiscal approach to stimulate the economy. Despite the pre-election talk of the benefits of cheap money, there is a widening recognition that we placed too much emphasis on cheap money and increased federal expenditures during the 1958 business recession, and have suffered by neglecting the possibilities of stimulating the economy by tax changes. We have a great deal to learn out of successes abroad with fiscal programs which offered tax concessions while keeping restraint on government expenditure.

Moreover, we may recall that tax reductions helped immensely in raising the United States out of both the 1949 and 1954 business recessions. Well-designed tax measures can give a sustained boost to the economy and in particular to those activities that generate revenues. The opportunity to stimulate activity by tax reform is great because we have inherited, from the wars, a system which puts penalties on progress.

One specific idea — brought forward in recent weeks — is to reduce or suspend withheld personal income taxes for a few months. This has a simple appeal: if there is a deficiency of purchasing power, the most obvious step for government would be to cease taking so much away from the citizen before he even has a chance to spend it. And the advantages are clear: the effect would be immediate and also reversible, something that cannot be said of increased federal spending. But the disadvantages are no less clear. A temporary tax cut would be a short-lived prop. It could involve a sizable loss of revenue — and need for deficit financing — without lasting benefit. It would further postpone getting down to the brass tacks of income tax rate reform.

The need is to raise the horizons for national progress by raising the horizons for individual progress. Our national achievement is the summation of individual achievements. This means action to stimulate human energy, the root of all accomplishment.

The complacent statement is often heard that there are no visible deleterious effects from the tax system. Practical observers know better. Mr. J. S. Seidman, president of the American Institute of Certified Public Accountants, predicts:

Our tax laws are heading for a revolution. That is because there is something fundamentally wrong with any system where taxes instead of common

sense run our lives. Yet that is the score today. Good judgment takes a back seat to taxes in deciding things like where we live, what we do with our money, what we say in our wills.

There are rationalizations, to be sure, that the higher income taxes are, the harder people work to overcome them. These theories do not work out in practice. If they did, our progress would not be suffering so conspicuously in comparison with the accomplishments of other nations where the truth is recognized that the power to tax is the power to destroy. Confiscation of the main fruits of a man's efforts — as the Soviets discovered — is no way to encourage him to greater efforts. Taxes can break the spirit of a people as well as their respect for law.

### **Spiritual Health**

This is no Twentieth Century discovery. Ibn Khaldun, 600 years ago in his classic *Prolegomena to Universal History*, pointed out how tax increases grow with the spread of luxurious habits of the government:

People get accustomed to this high level of taxation, because the increases have come about gradually, without anyone's being aware of who exactly it was who raised the rates of the old taxes or imposed the new ones.

But the effects on business of this rise in taxation make themselves felt. For business men are soon discouraged by the comparison of their profits with the burden of their taxes, and between their output and their net profits. Consequently production falls off, and with it the yield of taxation.

The rulers may, mistakenly, try to remedy this decrease in the yield of taxation by raising the rate of the taxes; hence taxes and imposts reach a level which leaves no profits to business men, owing to high costs of production, heavy burden of taxation, and inadequate net profits. This process of higher tax rates and lower yields (caused by the government's belief that higher rates result in higher returns) may go on until production begins to decline owing to the despair of business men. . . .\*

The paramount goal of the United States is not to create despair among enterprising people but rather — as the President's Commission on National Goals reported a month ago — “to guard the rights of the individual, to ensure his development, and to enlarge his opportunity”:

The very deepest goals for Americans relate to the spiritual health of our people. . . . Our material achievements in fact represent a triumph of the spirit of man in the mastery of his material environment.

While the report spoke of the need for “an overhaul of the tax system . . . to improve the climate for new investment and the balancing of investment with consumption,” it did not say

\*Translated by Charles Issawi, *An Arab Philosophy of History*, John Murray, Ltd., London, 1950.

anything specifically about steeply progressive personal income tax rates. A member of the Commission, Mr. Crawford H. Greenewalt, commented that it was "a pity that a Report which speaks so eloquently of the rights of the individual should condone legislative strictures limiting him in some cases to less than nine per cent of the fruit of his labor."

Indeed, there is nothing in our society that carves so precisely at the heart of individual efforts toward advancement as the personal income tax progression. Taking half or more of taxable income beyond \$16,000, it throttles capital accumulation, the ability of small unincorporated businesses to grow, and the opportunity of people generally to earn financial independence. As the following article shows, governments abroad have done a much better job of getting away from the extremes of taxation on income and private capital accumulation. Our failure to do as well in this direction — and correspondingly to give greater latitude for economic growth — is explained by political inertia.

The question is often raised as to whether we can afford to reform our tax structure. A more pertinent question is whether we can afford *not* to if we want to spur people to get ahead by exerting their energies and ingenuity. The necessity of a thorough revision of our tax system involves not only our domestic economic vitality, but our ability to preserve American leadership in an increasingly competitive world.

### **Agenda for Tax Reform**

Both political parties, during the course of the election campaign, gave attention to the need for tax reform. The Republican platform emphasized changes to stimulate individual incentive and encourage business investment in order to spur national growth. The Democratic platform similarly urged tax reform to "increase legitimate incentives for growth" and also emphasized the desirability of closing "loopholes" in the tax laws. Senator Kennedy, now President-elect, in a statement issued on October 18, advocated tax reform to "broaden the tax base and lower the extremely high rates that cut down business and personal incentives."

There is widespread agreement that the present federal tax system is urgently in need of reform. The Ways and Means Committee of the House of Representatives, which originates all revenue legislation, has had the question under close study for years, gathering data, soliciting expert opinion, and taking thousands of pages of testimony. During the 86th Congress, 1959-60, the Committee published 3,685 pages on the subject

of broadening the tax base for the purpose of achieving lower income tax rates. Many well thought out proposals, like the Sadlak-Herlong and Herlong-Baker bills, have been offered for consideration. Business groups, such as Chambers of Commerce, the National Association of Manufacturers, and the Committee for Economic Development, have dealt with the subject, giving earnest attention to the revenue requirements of an expensive government machinery as well as to the need to lower tax impediments to economic progress. But nothing has been done save piecemeal revision, usually with the effects of making the tax laws even more bewilderingly complicated and increasing the backlog of tax cases awaiting court interpretations.

The federal tax system is open to the following general criticisms:

1. It is too complicated.
2. Taxes are concentrated too much on employment, the development of taxable income, and capital accumulation.
3. The progressive rates ascend to such heights as to defeat their purpose of raising revenue.
4. The income tax base is so narrowed by exemptions, allowances, and deductions that rates must be high.

These points are interrelated. For example, tax laws must be complicated — and exemptions, allowances, and deductions must be numerous — because the economy could not otherwise function under such a stiff rate structure.

### **Competitive Handicaps**

In a day when we are concerned with a balance-of-payments problem, and the ability of American business to compete in world markets, it is vital to consider the disadvantages under which U.S. business operates. One disadvantage, widely publicized, is the element of higher wage costs. A second disadvantage — much less widely understood — is the severity of our taxation on employment, income, and capital accumulation. Individual and corporate income taxes, estate and gift taxes, and employment taxes are relied on for 82 per cent of the total revenues of the Federal Government.

The core of the problem is the income tax rate structure. In fact, our corporate rates are often effectively higher than the nominal rate schedule, because of the inadequacy of capital consumption allowances. Bipartisan support has developed in favor of revision of depreciation rules. President-elect Kennedy, in his October 30 state-

ment addressed to the balance-of-payments situation, said:

... we must stimulate plant modernization programs which are vital both to increased production and to building industrial facilities which can compete successfully with the modern plants of Europe and the Soviet Union. Wherever we are certain that tax revision—including accelerated depreciation—will stimulate investment in new plant and equipment, without damage to our principles of equity, we will proceed with such revision.

In this age of rapid technological change mixed with inflation, growing amounts of capital must be continuously poured into any business that wants to expand. Over the 13 years, 1947-59, the massive sum of \$300 billion was expended by U.S. corporations on plant and equipment and a further \$168 billion was needed to cover increased working capital requirements.

If we are to speed our rate of progress, and put in place expensive plant and machinery to make efficient use of the growing labor force, even bigger sums will be needed in the years ahead. More flexible depreciation is one way of tackling this problem.

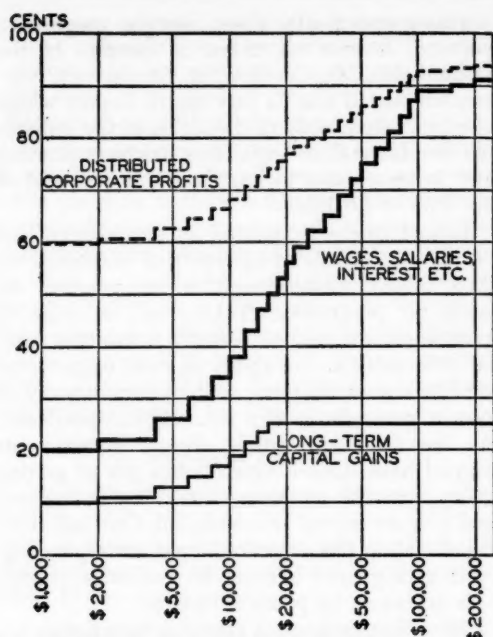
As was documented in our September 1960 *Letter*, governments in Western Europe allow faster write-off of new investment in tax accounting. Some European countries have permitted revaluation of asset values—and hence depreciation allowances—in recognition of the higher replacement costs resulting from inflation. Others grant investment allowances over and above original costs, thus permitting total deductions greater than the historical cost of a machine. More broadly, the acceleration of depreciation by special allowance is common practice. In some cases, these special provisions have permitted deductions in the year of investment approaching half the cost.

It is worthy of comment that even socialist governments have pursued liberal policies in the matter of depreciation charges. This was true, for example, under the former Labor Government of England, which introduced special allowances. Sweden has set some examples of the ultimate in liberality in depreciation allowances.

#### Corporate Tax Rates

Reform in depreciation allowances which affects only the timing of tax liabilities is no substitute for income tax rate reform. Our highest rates of tax are on corporate profits paid out in dividends, as the chart shows.\* The compounding of corporate and personal taxation, for example, gives a 62.6 per cent effective rate of tax

\*See the July 1960 issue of this *Letter* for a fuller discussion.



U.S. Taxation of One Additional Dollar of Income As Related to Tax Bracket of Recipient  
(Logarithmic scale for personal income brackets)

for a person in the \$4,000 to \$6,000 tax bracket, and the top rate goes all the way up to 93.8 per cent. These calculations are after allowance for the limited 4 per cent dividends-received credit. Other nations go much further in crediting to shareholders taxes paid by corporations.

Methods of taxing corporations and their shareholders vary radically from one country to another. It is a pity that greater attention has not been given to foreign tax systems for there is a great deal that we could learn from the experience abroad. So far as corporate net income distributed in dividends is concerned, some degree of double taxation is common. As the table shows, where the tax paid by the corporation is comparatively high, a large part is construed more or less as a tax on the shareholder withheld by the corporation. In other words, while the individual, on his personal income tax return, may be required to report a sum larger than he actually received, he gets a substantial credit for the corporate tax paid.

In light of the more liberal adjustments which other nations make to mitigate double taxation of corporate income distributed as dividends, it is ironical that our 4 per cent dividends-received credit has been under sharp attack as "an unjust loophole." In contrast to our 4 per cent, a 20 per cent credit is given in Canada while divi-

### Taxation by Central Governments of Corporate Profits Distributed as Dividends

	Maximum rate paid and withheld by corporation	Credit allowed individual shareholder
France .....	62%	24%*†
Netherlands .....	54.95	15†
United States .....	52	4
United Kingdom .....	51.25	38.75‡
Japan .....	50.90	30
Canada .....	50	20
Belgium .....	45.31	30†
Germany .....	42.58§	25†
Sweden .....	40	0
Australia .....	40	0
Switzerland .....	35.60	27†
Norway .....	30	0
Union of South Africa.....	25	33.33-100
Italy .....	20	8

\*Credit is 8% against taxable income and 16% against personal tax liability. †Deducted at source and credited to individual shareholder. ‡The individual, if subject to surtax rates on his personal income tax return, must, however, pay the surtax on the gross dividend actually declared rather than the net dividend actually received. §Ignoring the variable effect on the tax base of property tax on net worth.

dend recipients in the United Kingdom are credited with the 38¼ per cent standard tax rate already paid by the corporation. A minimum dividend credit of 33½ per cent is granted in the Union of South Africa to taxpayers with incomes beyond £2,300 (\$6,440), scaled upward to 100 per cent credit for those with incomes below £1,300 (\$3,640).

### Undistributed Profits

The U.S. Government is a majority shareholder in the profits of every substantial American corporation. On taxation of undistributed corporate profits, the general U.S. rate of 52 per cent applies. This is higher than in any other leading industrial nation, as the accompanying table shows. The top rate in many countries abroad is well below 50 per cent, and, in the case of Belgium

### Maximum Tax Rates Imposed by Central Governments on Undistributed Corporate Profits

United States .....	52%
United Kingdom .....	51.25
Germany .....	51
France .....	50.98*
Canada .....	50†
Netherlands .....	47
Japan .....	45.44‡
Belgium .....	40§
Australia .....	40
Sweden .....	40
Norway .....	34
Union of South Africa.....	25
Italy .....	20¶
Switzerland .....	8§

\*Includes tax levied on reserves of accumulated profits. †Includes 3% tax for old age security contribution. ‡There is an additional 10% tax on retained profits of closely held corporations. §Taxes paid in previous year are deductible in determining taxable income, thus lowering the effective burden. ¶An extra 25% tax is levied on profits (beyond certain limits) not distributed. ||In addition, there is a 15% tax on profits in excess of 6% of capital and reserves.

and Switzerland, the effective burden is even lighter than the stated rate indicates since taxes paid in one year are deductible from taxable income in the next.

Our 52 per cent general rate of corporate tax is supposed to come down to 47 per cent on June 30, 1961. This was the rate prior to the Korean War but the 52 per cent temporary emergency rate has been extended from year to year ever since. If the Congress wishes to energize the U.S. economy it can do so by letting the corporate rate come down and thus increasing the opportunities of business to absorb rising cost pressures from other directions, shave prices to the benefit of everyone, or enlarge the plowback of profits to help build the equity capital base for a growing economy.

### The Personal Income Tax Progression

The most widely condemned feature of our federal tax system is the steepness of our progressive tax rates on personal income. An individual with taxable income of \$16,000 finds that the Federal Government becomes an equal partner in any earnings beyond that amount. Beyond \$50,000, the tax collector demands three quarters. Beyond \$200,000 the taxpayer is called upon to pay 91 per cent. On top of the punishing federal rates, many states (and some cities) levy income taxes which further cut the value of earning additional money.

The progressiveness of personal income taxation can be most simply measured by the top rate. Here, as the table shows, we can lay claim to the highest rate in the world. The United Kingdom, former holder of this distinc-

### Maximum (Marginal) Rates of Personal Income Taxation Imposed by Central Governments

United States .....	91%
United Kingdom .....	88.75
Puerto Rico .....	32.95
Canada .....	80
Ireland .....	77.50
France .....	73*
Netherlands .....	72.50
Japan .....	70
Australia .....	66.67
Belgium .....	65
Sweden .....	65
Greece .....	63†
Austria .....	59.34
Italy .....	58
Mexico .....	33-55‡
Norway .....	55
Germany .....	53
Denmark .....	52.38§
Union of South Africa.....	47.50
Switzerland .....	8

\*Includes an 8% complementary tax on nonwage income. †Includes a 3% tax on investment income. ‡Tax rate applicable depends upon source of income. §Effective maximum, allowing for deductibility of previous year's tax, where income is stable.

tion, has been gradually shaving its rates and two years ago bequeathed us leadership in this department. (Denmark has a 110 per cent top rate but this is ineffective since income tax paid in one year is deductible from taxable income in the next.) It is no coincidence that the two countries at the top of the list in income tax progression are laggards in real progress.

Practically every plan for tax reform includes topping off the personal income tax progression at 50, 60, or 70 per cent as opposed to 91 per cent. The revenue loss would not be significant, particularly since the main effect of present rates is to impel the taxpayer to seek income which is tax-exempt, or income on which the tax liability can be deferred or converted into the form of capital gains. The final escape, of course, is emigration of persons and income to friendlier tax climates abroad.

The Congress has attempted to take the curse off excessive rates by adding to the list of special relief provisions. The present situation was described by Mr. Seidman as follows:

What are called "loopholes" are often Congress' way of apologizing for the high tax rates. There are special provisions to afford some taxpayers relief. For example the average taxpayer gets sick-pay tax-free. Married people are taxed more lightly through split income. Executives get a break through stock options, and investors have the cushion of capital gains. In effect, Congress sets high rates and then tears down some of the rate structure by allowing special benefits for some taxpayers. The trouble is that other taxpayers, who feel that they are likewise entitled to relief, then start helping themselves with all sorts of gimmicks.

This short-sighted approach has drawn us into a vicious circle in which excessive rates lead to a shrinking tax base, while the smaller tax base requires preservation of high rates to produce the needed revenue. Yet, we could achieve our revenue objectives at more reasonable rates if we broadened out the base. Chairman Wilbur D. Mills of the House Ways and Means Committee has calculated that:

If all the exceptional provisions now in the law were eliminated, if a uniform tax base were provided, while maintaining the present system of personal exemptions, we could collect the same revenue we now get from the individual income tax with a rate schedule in which the first bracket was nine per cent and the top bracket was 41 per cent.

Unless this self-defeating circle is broken through tax rate reform, further erosion of the tax base must be expected.

#### **Overdose of Progressivism**

When the Constitution was amended in 1913 to permit income taxation no limit was set on tax

rates. The initial top rate of tax was set at 7 per cent and the idea was ridiculed that "confiscatory" rates like 25 or 50 per cent might at some time be adopted. Nevertheless, we had rates as high as 77 per cent adopted in World War I and again as high as 94 per cent during World War II. But it is fair to say that confiscatory rates like these were never designed to be kept outside war emergencies. So far as people exposed substantial income to taxation at such rates, it was out of a spirit of patriotism.

Failures of the American economy to function more effectively can be attributed to an overdose of the "heavy progressive or graduated income tax" that Karl Marx in the Communist Manifesto suggested as a means of making "despotic inroads on the rights of property, and on the conditions of bourgeois production." For all his errors, Marx assessed correctly what this kind of taxation could do to a capitalistic country. Meanwhile, Khrushchev's Russia plans to do away with income taxation entirely.

Our type of society is seriously vulnerable to taxation on capital because we rely on private capital formation for progress. The steeply progressive personal income tax is a levy on capital accumulation. We also have heavy taxes on accumulated capital — gift and inheritance taxes — which require people to sell capital assets to raise money which government proceeds to spend. Unlike most other countries we also tax capital gains which are not income at all in the economic sense of the word.

A clear starting point for tax reform in the coming session of Congress is a scaling down of excessive rates which lead to pressures for special relief. If this is done boldly, consistent with revenue requirements, everyone can raise his estimate of the future of the U.S. economy.

#### **The World Gold Picture**

There is more interest in gold today than at any time during the past quarter century. Americans have become aware that the U.S. gold stock, so long the symbol of the paramount strength of the U.S. dollar, has declined to its lowest point since 1940. People are asking searching questions about the significance of the gold outflow for their jobs and savings.

On the threshold of 1961, gold not only attracts attention but also commands renewed respect. Few people any more would call gold "a barbarous relic," as the British iconoclast Keynes did a generation ago. The demand for the metal by foreign central banks and governments shows the prestige it has retained in the minds of those responsible for national monetary reserves. De-

mand for gold jewelry attests to the appreciation of people for the enduring value as well as beauty of the metal. The widely publicized gold rush in the London market has abated; but some feeling of suspense will persist until the new U.S. Administration shows by deeds its firmly expressed intention to defend the present value of the dollar and its soundness.

Russia, too, is in the world gold picture at the turn of the year. According to an official announcement, a new heavy ruble is being created equal to a gram of gold or \$1.11.

World gold production (excluding Russia) reached a new postwar peak in 1960—for the seventh consecutive year. Worth some \$1,180 million, last year's output was 4-5 per cent above 1959. It was over \$400 million higher than in 1945, at the end of the war, but still about \$100 million below 1940, the all-time high.

#### Estimated Gold Production in 1960 (In Millions of Dollars)

Union of South Africa .....	\$ 750
Canada .....	160
United States .....	58
Australia .....	38
Ghana .....	32
Southern Rhodesia .....	20
Colombia .....	15
Philippines .....	14
Republic of the Congo .....	13
Japan .....	11
Mexico .....	11
All Others* .....	58
<b>Total*</b> .....	<b>\$1,180</b>

\*Excluding USSR, Mainland China, and countries in their orbit.

The postwar rise in output is primarily explained by the increase in South Africa, which has made rich new discoveries and achieved economies of production to offset rising wage costs. In Canada, where the industry is offered government subsidies, output has held for five years within a range of \$158-160 million.

Russia's gold output is a guarded secret. Western observers put it somewhere between \$350 and 600 million annually. We are less in the dark regarding the gold Russia sells in Europe to balance out its international payments. From gold import statistics of other countries one can guess that the U.S.S.R. exported some \$250 million worth of gold annually during 1957-59. Russian offerings on the London market in the first 10 months of last year were running at half the rate of 1959.

#### Rising Private Demand

Gold mined in the United States is sold, at \$35 per ounce, either to the U.S. Treasury or to companies and dealers licensed by the Treasury

to buy gold for use in industry and the arts. Use for these purposes, including some entirely new industrial applications, has increased during recent years and now exceeds our current gold output; the difference is made up by releases from monetary stocks. Net consumption in 1959 amounted to \$88 million compared with \$63 million in 1958 and \$45 million in 1955. There is no gold coinage in the United States and residents are allowed to hold at home only coins of recognized numismatic value; they may hold gold outside of United States territory.

A major part of newly mined gold is sold in the London market, reopened in 1954. While the U.S. Treasury sells gold only to monetary authorities, the London market is open also to private interests. However, except for licensed domestic users, only residents of nonsterling countries may buy gold in London. Trading is generally conducted in U.S. dollars.

A comparison of new gold supplies (from Free World output and estimated Russian sales) with year-to-year increases in the total of official gold stocks makes it possible to get an approximate idea of the amounts absorbed by the arts and industry or by private holders.

#### Estimated Sources and Uses of Gold (In Millions of Dollars)

	Gold Production*	Reported Sales by USSR	Increase in Official Stocks*	Industrial Uses and Additions to Private Holdings†
1951	826	—	210	616
1952	850	—	250	600
1953	848	75	470	463
1954	897	75	650	322
1955	940	75	680	335
1956	978	150	480	648
1957	1,017	260	720	557
1958	1,049	220	665	604
1959	1,125	250	690	695
1960	1,180	n.a.	520‡	n.a.

\* Excluding USSR, etc. † Residual figures. ‡ Jan. - Sept. n.a. — Not available.

Source: Derived largely from *International Financial Statistics*, except gold production for 1960, which is a tentative estimate based on incomplete data.

Although data for 1960 as a whole are not yet available, it is apparent that the addition to official reserves out of new production was curtailed. The increase in the first nine months, according to the International Monetary Fund, was \$520 million. It is doubtful if much was added to this total during the fourth quarter when private demands increased substantially.

#### The Sources of Europe's Gold Gains

The deficit in the U.S. balance of payments, discussed in earlier articles in this *Letter*, has been supplying European central banks with dollars far in excess of needs for current payments. They have used some of these dollars to buy gold from the U.S. Treasury and also in the London market.

The following table helps trace the origin of changes in foreign monetary gold stocks during the past three years. The United Kingdom, the Netherlands, Belgium, Switzerland, and Austria — and also Japan — made substantial purchases from the U.S. Treasury. On the other hand, Italy and France made most of their gold purchases in the London market or elsewhere; Germany has bought no gold in the United States since early 1955.

**Changes in Monetary Gold Stocks of Selected Foreign Countries, January 1958 - September 1960**

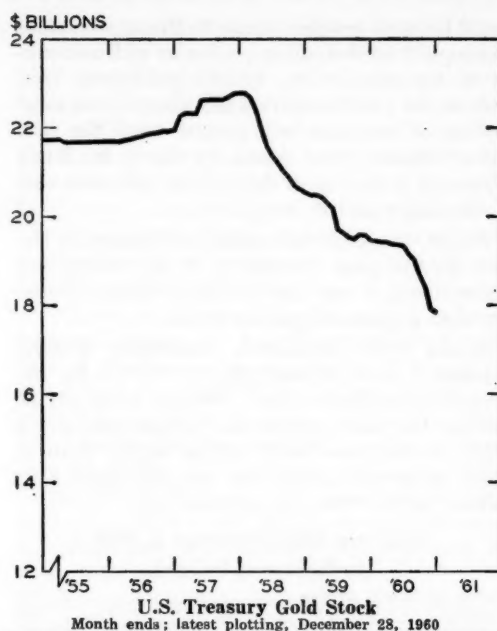
	(In Millions of Dollars)			
	Through Transactions with: U.S.	I.M.F.*	Other†	Gold Stock Sept. 30, 1960
Germany	\$ 0	\$ -114	\$ 461	\$ 2,889
United Kingdom	1,250‡	-163	-162‡	2,525‡
Italy	349¶	-68	1,261¶	1,994¶
Switzerland	355	0	-81	1,980
France	322	-66	790	1,627
Netherlands	436	-34	200	1,346
Belgium	426	-23	-219	1,094
Canada	0	-68	-143	894
Portugal	30	0	59	550
Venezuela	-65	0	-193	462
Austria	168	-6	28	293
Japan	187§	-63	97§	244§
All foreign countries	3,808	-1,052	2,160	19,434

\*Gold payments to the I.M.F. on account of capital subscriptions. †Residual figures; including gold acquired from new production, Russian sales, etc. ‡Through June 30, 1960. Additional \$200 million of gold was purchased from the United States in the third quarter of 1960. ¶Through June 30, 1960. §Through March 31, 1960. Additional \$15 million of gold was purchased from the United States in the third quarter of 1960.

Sources: Derived from data in *Federal Reserve Bulletin* and *International Financial Statistics*.

Beginning in the third quarter of 1960, with strengthening private demands driving up the London price, official gold buying shifted more and more to the U.S. Treasury, which sells at a fixed price of \$35.0875 per fine ounce (\$35 plus ¼ per cent handling charge). The London market price firmed slowly from a monthly average of \$35.09 in June to \$35.22 in September. Following the flare-up to \$40 per ounce on October 20, the London gold price settled down to \$35.84 in November and \$35.54 in December. Central bank buying in London ceased altogether as the price rose, though it normally would come forward to prevent a decline to \$35 or less. The U.S. Treasury, which offers \$34.9125 per fine ounce, has not been an important buyer on balance since 1956-57.

The \$5 billion decline in the U.S. gold stock during 1958-60 is shown in the chart against the background of movements since 1955. The drop came fast in 1958 as our balance of payments weakened sharply while generous Congressional appropriations and an easy money policy created fears of renewed inflation. The Federal Reserve's shift to a restrictive credit policy, supplemented by the Administration's successful efforts to rebalance the budget, helped check the gold outflow during 1959 and the first half of 1960 despite the persistent large payments defi-



cit. The accelerated gold loss during the second half of last year — notwithstanding a remarkable improvement in our merchandise trade balance — appears to have been aggravated by apprehensions that a new Administration taking office this month might use inflationary finance to spur economic activity and growth.

It should be noted that changes in the U.S. gold stock have been affected by transactions with the International Monetary Fund. Since the Fund's establishment, the gross total of gold taken from the official reserves of member countries and paid to the Fund runs to no less than \$3.8 billion. Of this amount, \$688 million was initially transferred by the United States in 1947, and a further \$344 million in June 1959, in payment of the gold portion of our subscription. Additional sums have moved from the United States to the Fund as other nations have purchased gold from the Treasury to pay the gold portions of their own subscriptions or to repay in gold, as required by the Fund statutes, part of their currency drawings. For example, France two months ago purchased \$117 million of gold from the United States to make the bulk of its final repayment of drawings received in dollars and German marks in 1957-58.

A substantial part of the Fund's gold has come back to the U.S. Treasury. Since 1956, the Fund has sold \$600 million to the Treasury to replenish its dollar resources and \$800 million to purchase U.S. Treasury bills and thus gain earning assets. Of these transactions, \$600

million were carried out during the 1958-60 period of drain on the U.S. stock — \$300 million in the second half of 1959 and \$300 million a month ago. In connection with its conversions of gold into Treasury bills, the Fund received assurances that the Treasury will resell the gold to the Fund at short notice, if requested.

The United States now holds almost 45 per cent of the Free World's monetary gold stock — approximately the same proportion as in the late 1920's. In 1949, when the U.S. stock was at its peak, the figure was 70 per cent — a clearly excessive share. The wheel has thus turned full circle.

It is not so much the fact that our gold stock today is no more than \$17 or 18 billion that is a matter of concern. It is the rate of loss that causes apprehension. There has been, however, no run on the U.S. stock in the sense of wholesale conversions of dollar holdings into gold. In fact, foreign holdings of dollars continued to increase last year.

#### **A Monetary Sputnik?**

Russia also attaches vital importance to gold. It is outranked only by South Africa as a gold producer. It sells some of its gold against sterling and other currencies and has an accumulated stock estimated by Western observers at somewhere between \$4 and 8 billion.

Russian monetary theory adheres to the traditional view that gold is the foundation of currency. The ruble has a legally prescribed gold content and Russia's central bank is required to cover its note issue with a 25 per cent gold backing. This, it is thought, makes Russian currency "tokens of gold." Karl Marx said in *Das Kapital* that "only in so far as paper money represents gold, which like all other commodities has value, is it a symbol of value."

But Russia's attitude toward gold has not always been true to this classical concept. Lenin wrote in 1921 that "when we conquer on a world scale, I think we shall use gold for the purpose of building public lavatories in the streets of several of the large cities of the world." So long as capitalism remained strong, however, Lenin regarded gold as an indispensable weapon in Russia's hands: "We must save the gold . . . , sell it at the highest price, buy goods with it at the lowest price." High-ranking Russians have repeatedly advocated a rise in what they call the "artificially low price of gold" imposed by the United States.

The Russian ruble has suffered a number of devaluations under the Soviets, typically involving some degree of confiscation of the fruits of saving. Against this background, Russia's an-

nouncement last November that the ruble, beginning January 1, would be "worth" more than the dollar stirred some wonder. What is to be done, from January through March 1961, is to convert old rubles, nominally worth 25 cents, into "heavy" rubles at a rate of ten to one; at the same time, a zero will be removed from all prices, wages, and values. The new heavy ruble becomes equal to \$1.11 in U.S. money.

The operation glosses over the fact that the old ruble is devalued from 25 to 11 cents, or by 56 per cent. In the absence of any tinkering, the new ruble — replacing as it does ten old rubles "worth" 25 cents each — should be "worth" \$2.50. Instead, it is put at \$1.11.

The 25 cent ruble was — it is generally agreed — grossly overvalued; Russia itself recognized the fact when it established in 1957 a special tourist rate of 10 cents to the ruble. The currency reform puts Russian domestic prices more in line with prices abroad. This will simplify comparisons of relative costs of exports and imports of various goods and make for easier calculation of the profitability and economic advantage derived from foreign trade. It reduces the need to subsidize exports and thus makes Russia less exposed to charges of "dumping."

#### **Freedom for Money**

The question remains as to whether nations receiving Soviet credits, and trading with Russia, might be pressed to accept the ruble as a currency in which they would conduct trade and keep monetary reserves — as they do in dollars and sterling.

To accept ruble credits is one thing; to keep funds in rubles by free choice is another. Money in Moscow is blocked money, subject to the strictest exchange control in the world and usable only at the pleasure of the authorities. Money in New York is freely spendable or lendable, practically anywhere, for citizen and foreigner alike. So long as we maintain this condition, keep our prices stable, and preserve equivalence of the dollar to gold, the ruble can never offer a serious challenge.

Like the Russians, we cannot do business in gold alone. There is not enough of it. And in any case the metal cannot compete with credit for convenience in effecting payments. Trade and prosperity cannot survive without credit, without trust in performance upon promise. The present gold problem thus reduces itself to keeping trust in dollars — by repressing inflationary tendencies as they arise and dealing with the balance-of-payments deficit through means that preserve and protect the freedom of people to use their dollars as they think best.

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